Deutsche Bank

A Wall St Perspective on the Defense Industry

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Myles Walton, PhD, CFA
Myles.Walton@db.com
617.217.6259

Defense Industry Investment Summary

2011/12 Defense Investing Themes

On the Wrong-Side of Cycle

"Defensive" Qualities

Ops/Gates Uncertainty

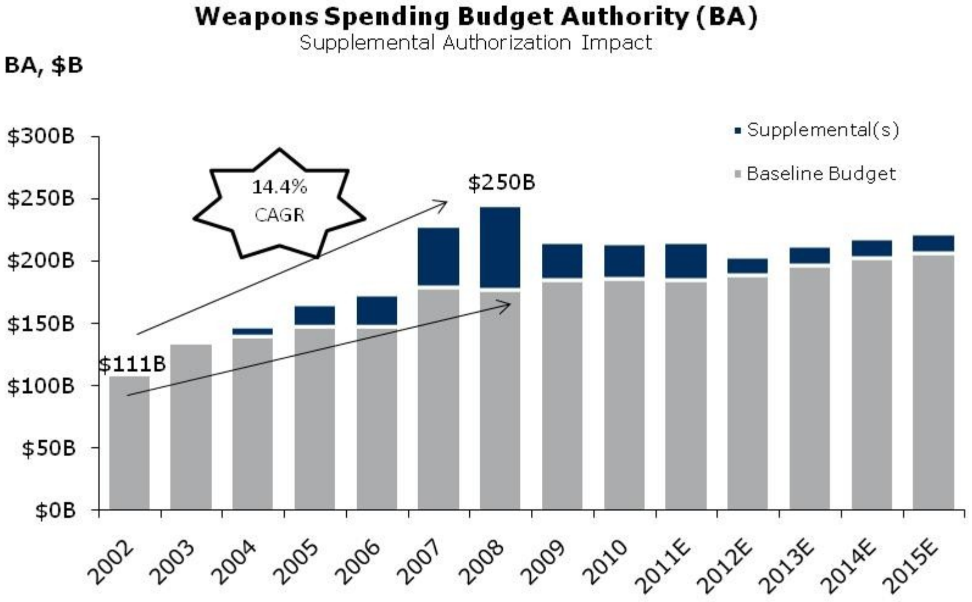
Acq Reform

Deficit, Deficit, Deficit

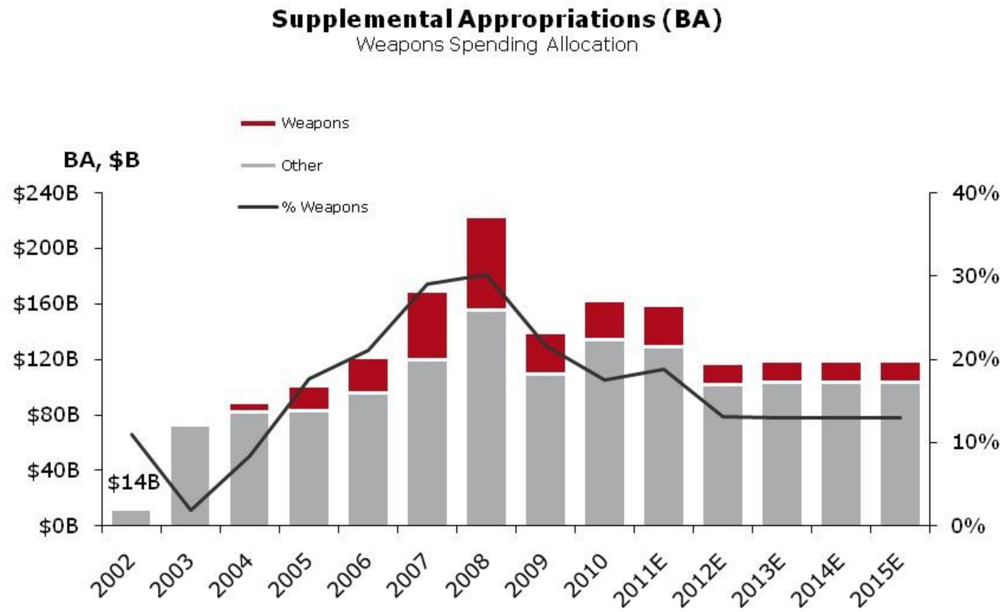
Valuation on Defense Stocks Reflects:

- Decelerating/declining growth environment
- Earnings growth potential from capital deployment, pension recovery; solid dividend yields (3-4%)
- Long-term visibility from backlogs/budgets
- Free cash flow after dividends of ~$15B over 2011/12 leaves plenty to deploy in acquisitions, dividend increases and share repurchase
- Growth opportunities (acquisitions and organic) beyond typical weapons spending include homeland security, federal IT, and MRO
- Fear on sales declines is evolving to fear on margins/cash
- Incremental risk on CRs

Defense Budget Dynamics



Source: Department of Defense



Source: Department of Defense

Supplemental Appropriations have protected baseline budgets from operations cannibalizing investment accounts…

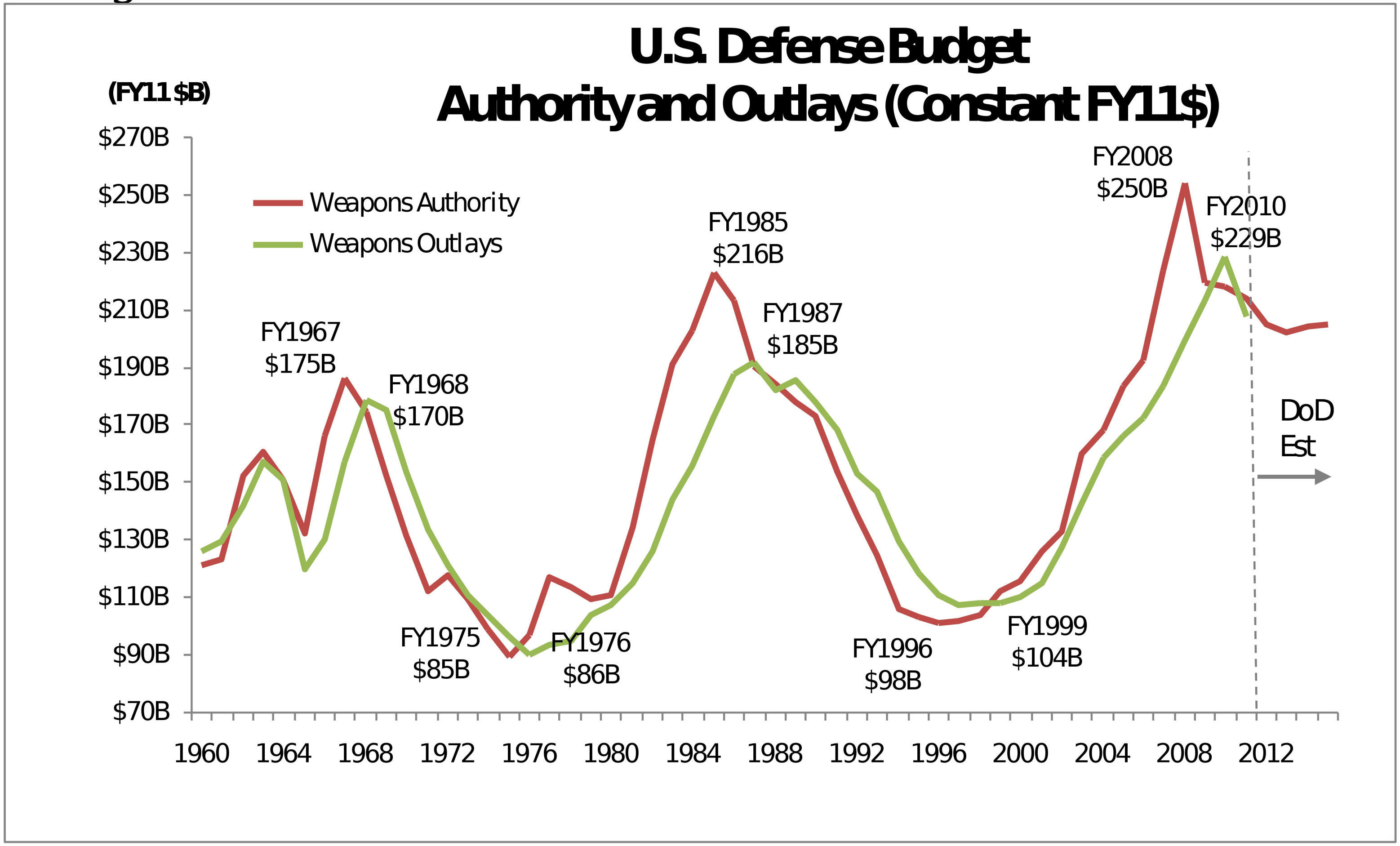
…share of supplemental spending towards weapons spend has trailed off, but still headwind

Supplementals protect baseline programs and bolster budgets of war-torn equipment

Our Thinking on Defense Spending Cycles

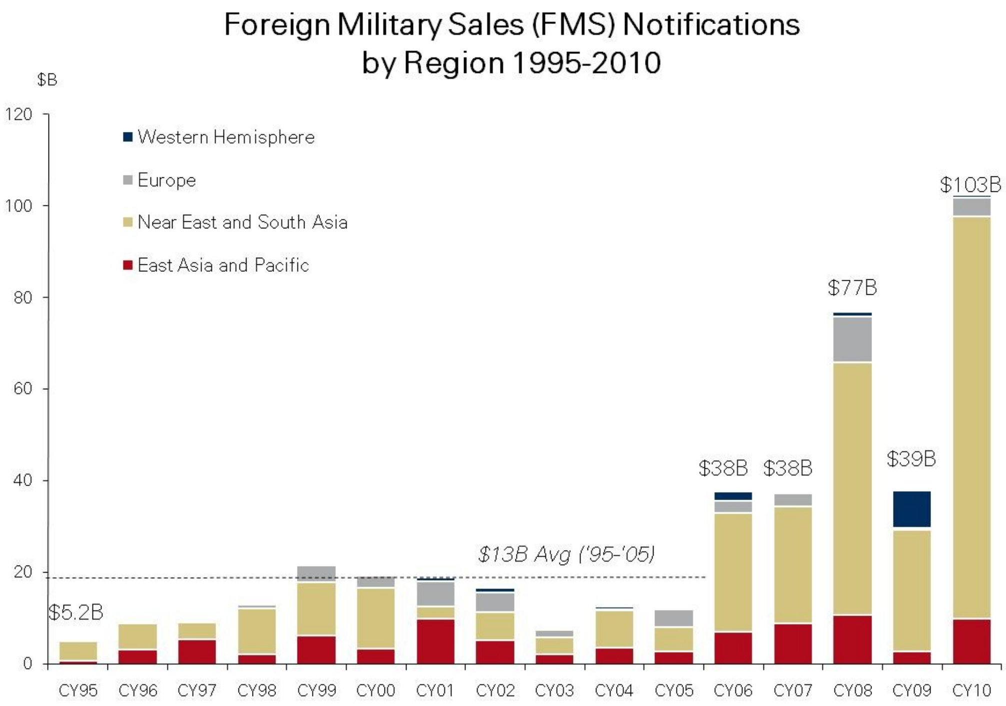
Drivers to Defense Spending

1. Threat: Domestic Fears Take Center Stage
2. Available Funds: Scarcity Builds
3. Washington World View: Unknown

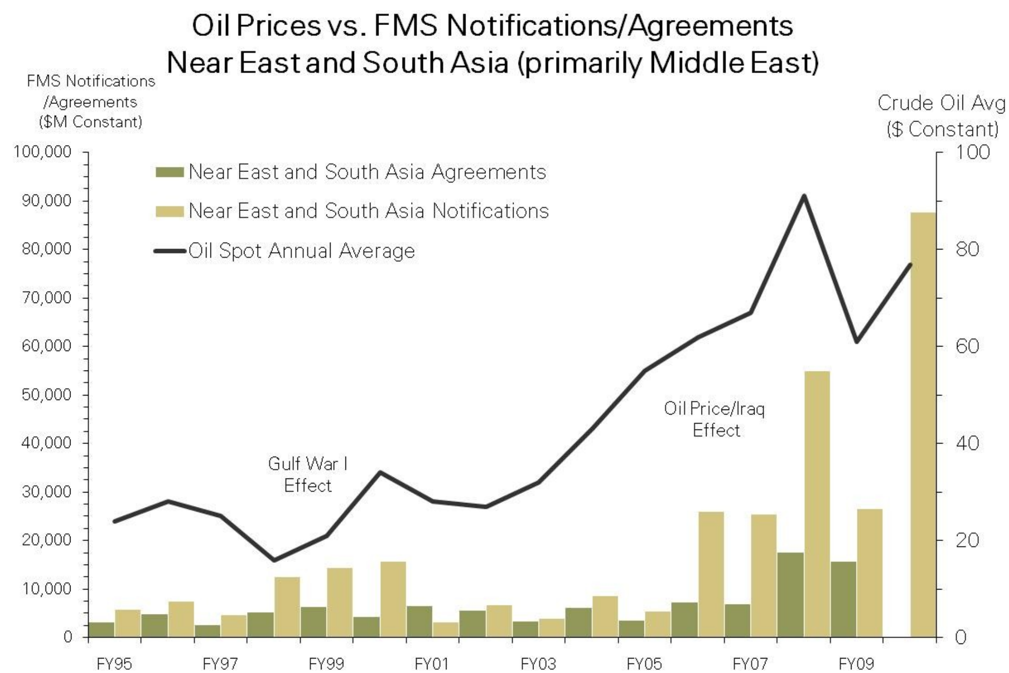


Cycle Drivers Have Turned Negative

Diplomacy Through Arms



Source: Department of State



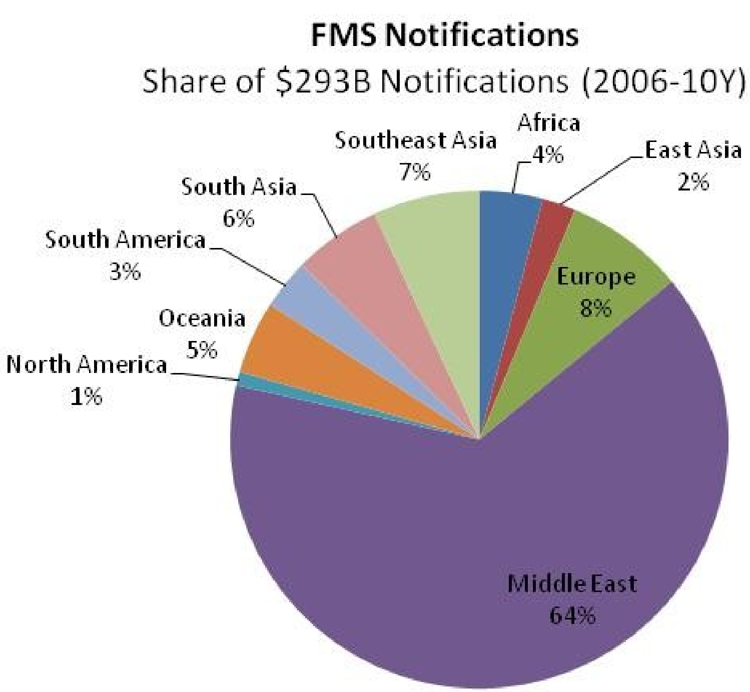
Source: DoD DSCA FY89-05 Fact Books, Congressional Notifications

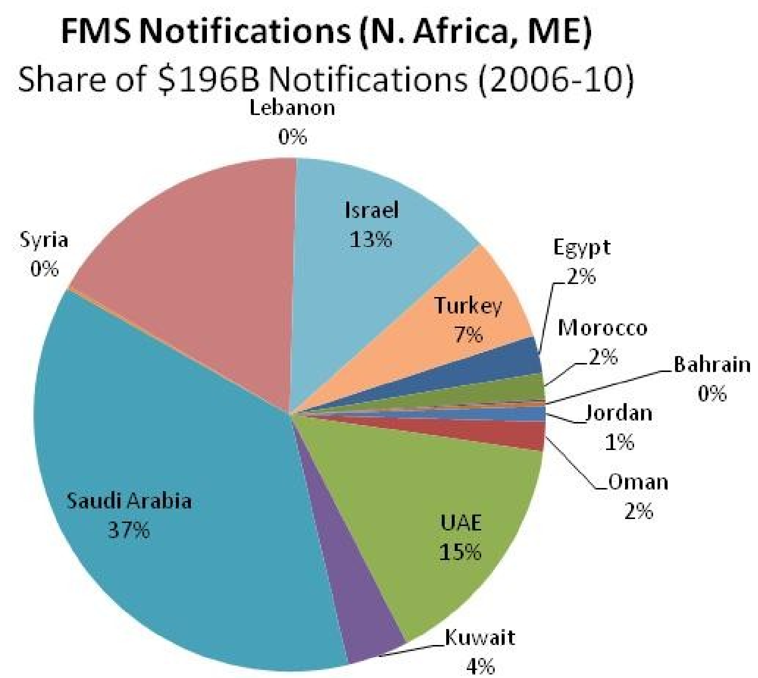
CY06-CY10 FMS notifications =4x prior decade's run-rate.

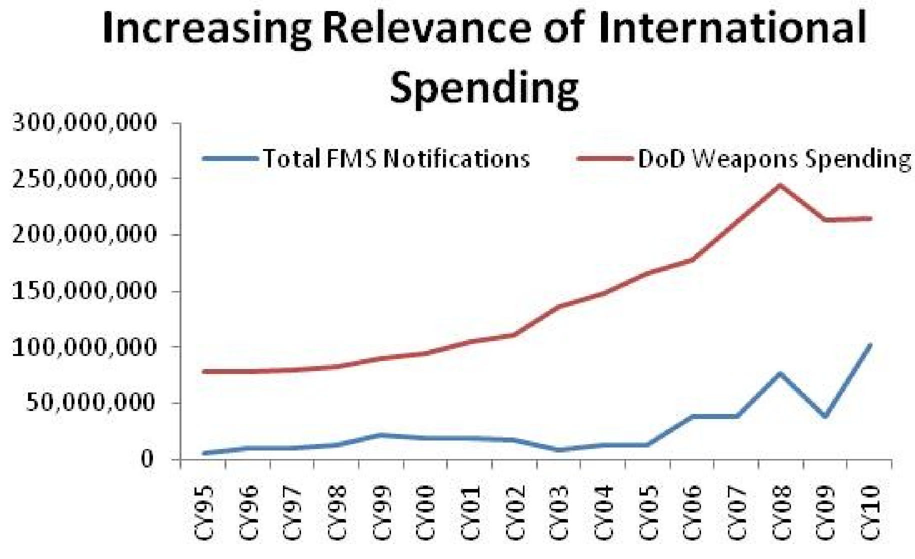
Buoyed by weak $, surging oil revenue & isolate-Iran policy, Middle Eastern countries

International acceleration should dampen downturn

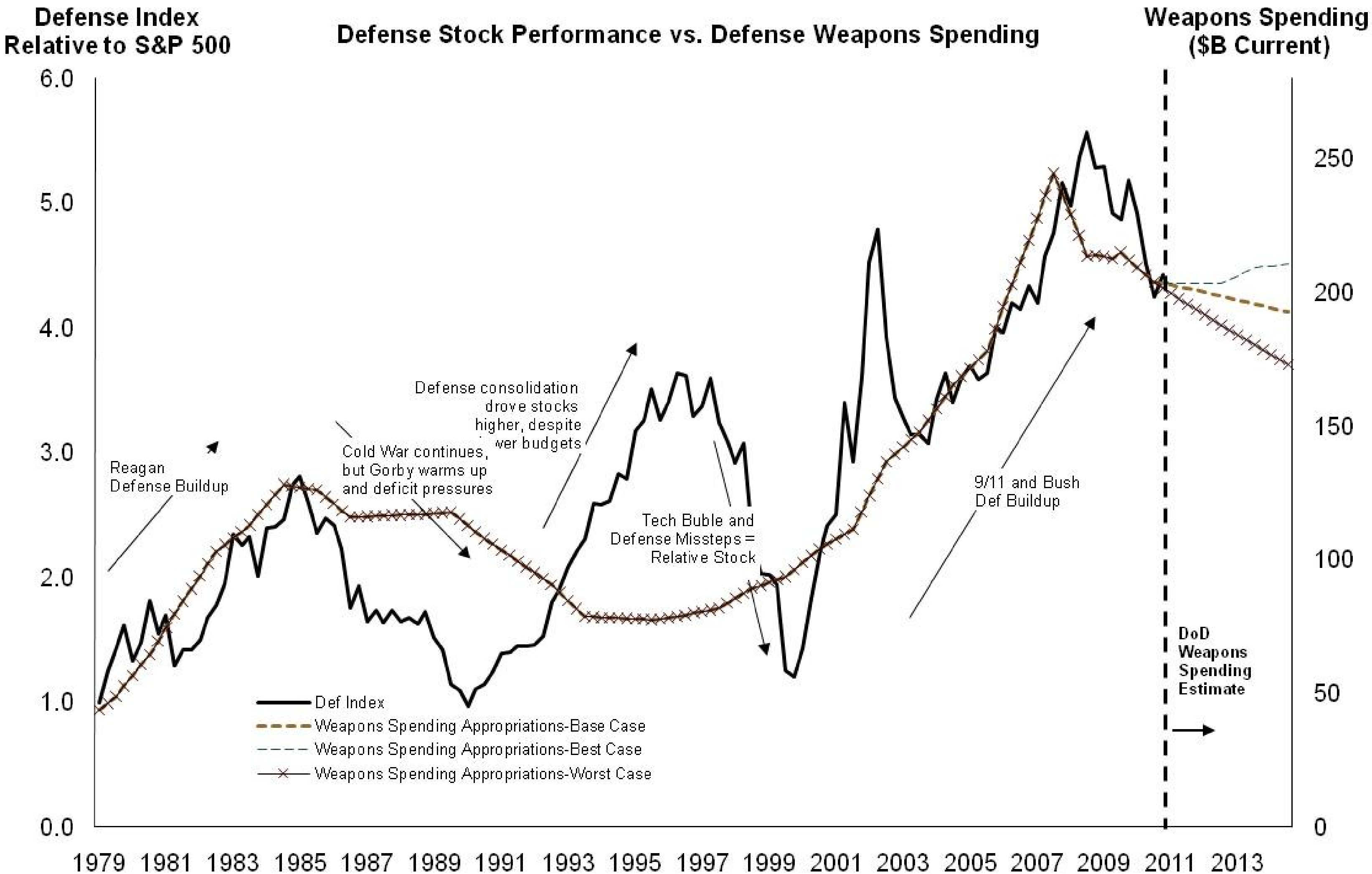
Increasing Relevance of International Sales







Budgets and Stocks



Stocks include: NOC, GD, LMT, RTN, LLL, ATK, McDonnel Douglas, E-Systems, Martin Marietta, Grumman

Correlation of Stock Relative Returns to DoD Spending is Hard to Escape

Investment Positives: Multi-year Visibility

Backlog Analysis

($MM)	**2003A**	**2004A**	**2005A**	**2006A**	**2007A**	**2008A**	**2009A**	**2010A**
General Dynamics Total*	34,332	34,905	34,136	35,974	34,576	51,648	46,221	41,740
Lockheed Martin Total	76,899	73,986	84,188	75,900	76,700	80,900	78,000	78,200
Northrop Grumman Total	58,154	58,080	55,983	61,021	63,665	78,052	69,186	64,183
Raytheon Total*	25,087	29,611	31,248	33,595	36,614	38,884	36,877	34,551

(% Growth)	**2003A**	**2004A**	**2005A**	**2006A**	**2007A**	**2008A**	**2009A**	**2010A**
General Dynamics Total*	57%	2%	(2%)	5%	(4%)	49%	(11%)	(10%)
Lockheed Martin Total	9%	(4%)	14%	(10%)	1%	5%	(4%)	0%
Northrop Grumman Total	NA	(0%)	(4%)	9%	4%	23%	(11%)	(7%)
Raytheon Total*	19%	18%	6%	8%	9%	6%	(5%)	(6%)

Yrs B/L on Next Year's Sales	**2003A**	**2004A**	**2005A**	**2006A**	**2007A**	**2008A**	**2009A**	**2010A**
General Dynamics Total*	4.9	4.1	3.3	2.7	2.2	2.9	2.3	1.9
Lockheed Martin Total	2.2	2.0	2.1	1.8	1.8	1.8	1.7	1.7
Northrop Grumman Total	1.9	1.9	1.9	1.9	2.0	2.3	2.0	2.3
Raytheon Total	1.5	1.6	1.6	1.6	1.6	1.6	1.5	1.3

Source: Company reports.

Solid backlogs add to out-year visibility, though starting to recede…
Not as robust down the chain

The Benefit Of Stable/Growing Budgets

Large-Cap Defense Margin Picture

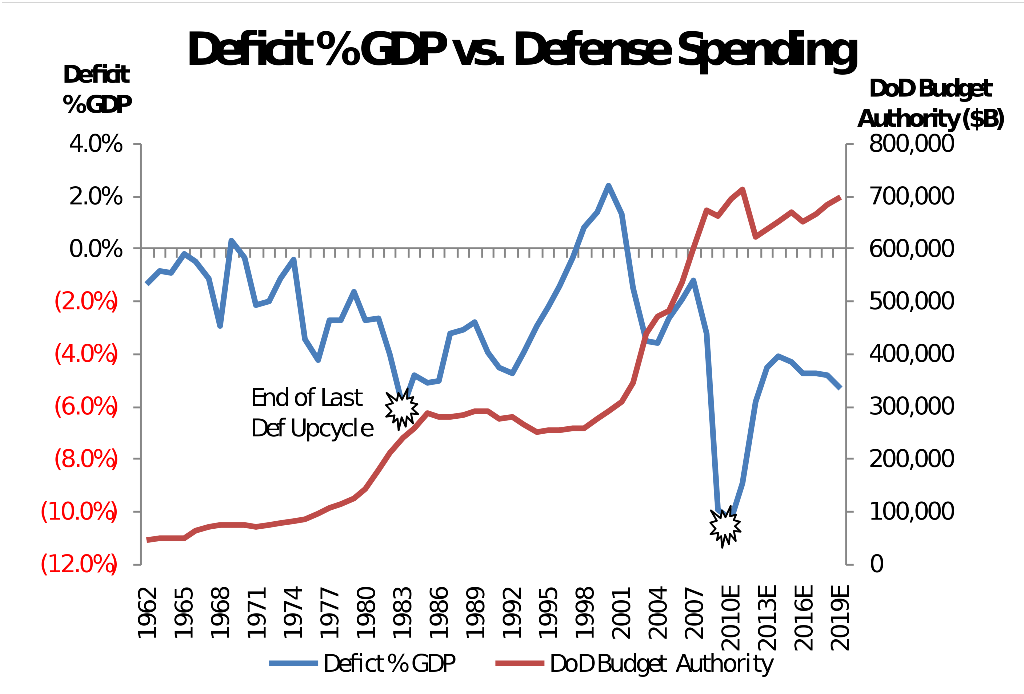
Segment Margins	FY03A	FY04A	FY05A	FY06A	FY07A	FY08A	FY09A	FY10E	Change FY03-FY10
General Dynamics	8.8%	10.1%	10.3%	10.9%	11.4%	12.5%	11.5%	12.0%	322 bps
Lockheed Martin	7.8%	8.4%	9.2%	10.2%	11.2%	11.6%	11.4%	11.1%	336 bps
Northrop Grumman	7.3%	7.7%	8.0%	9.3%	9.8%	8.5%	8.7%	9.3%	205 bps
Raytheon	8.5%	11.3%	11.4%	12.9%	13.2%	13.1%	13.1%	11.9%	340 bps
Average	**8.1%**	**9.4%**	**9.7%**	**10.8%**	**11.4%**	**11.4%**	**11.2%**	**11.1%**	**301 bps**

ROIC (adjusted for one-time and pension)									FY03-FY10E
Lockheed Martin	11.6%	14.1%	17.2%	18.9%	20.7%	20.7%	20.7%	17.7%	612 bps
Northrop Grumman	5.1%	6.3%	6.7%	8.0%	8.9%	8.0%	9.6%	11.7%	657 bps
Raytheon	5.2%	7.1%	7.4%	8.8%	10.0%	10.9%	11.9%	11.6%	631 bps
General Dynamics	11.9%	13.0%	13.8%	15.0%	16.0%	16.8%	15.1%	15.3%	341 bps
Average	**8.5%**	**10.1%**	**11.3%**	**12.7%**	**13.9%**	**14.1%**	**14.3%**	**14.1%**	**560 bps**

The key to success by defense contractors this cycle has been improved return on invested capital as much as improved margins

**ROIC corrected for pension and unusual items*

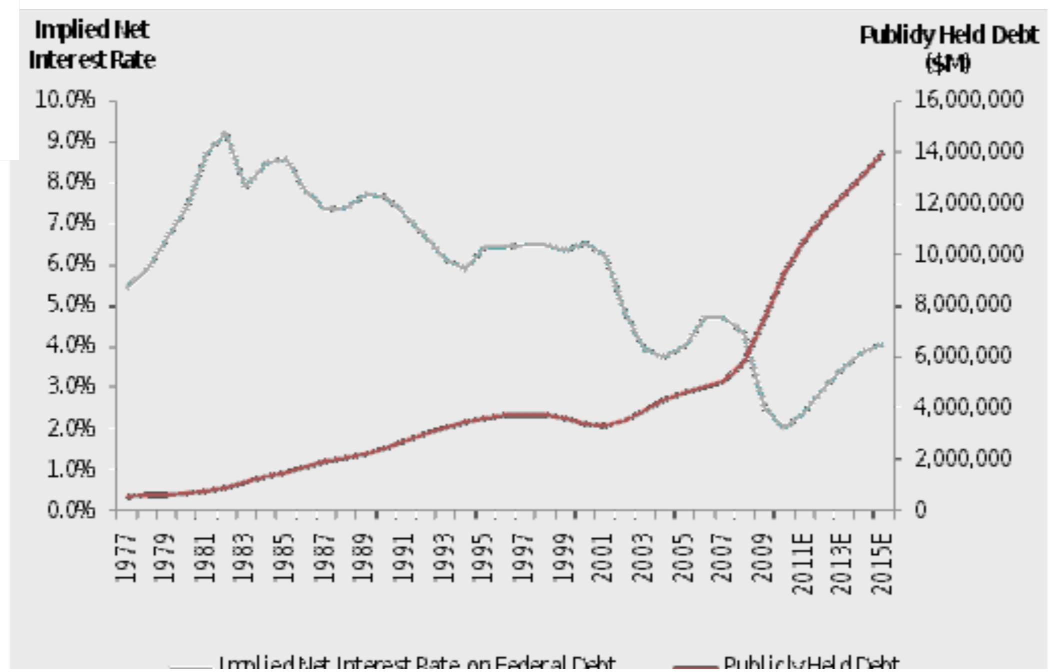
Deficits Aren’t Going Away By Themselves.



Deficits were the catalyst to the last downcyle

• Gramm-Rudman-Hollings amendment/Pay-Go took spending control away from DoD

• “Cutting Defense in this Fiscal Climate is Like Following Off a Log”

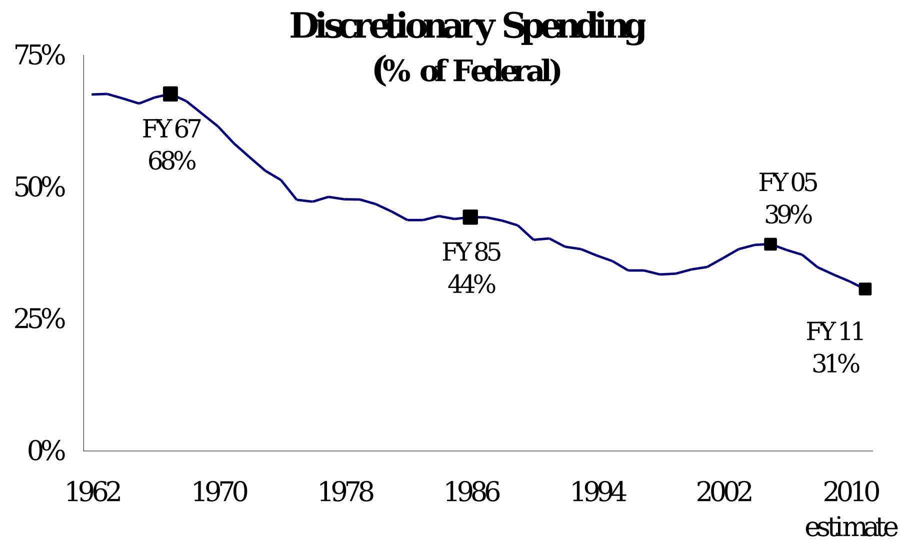


Low Interest Rate Are Allowing Spending to Continue

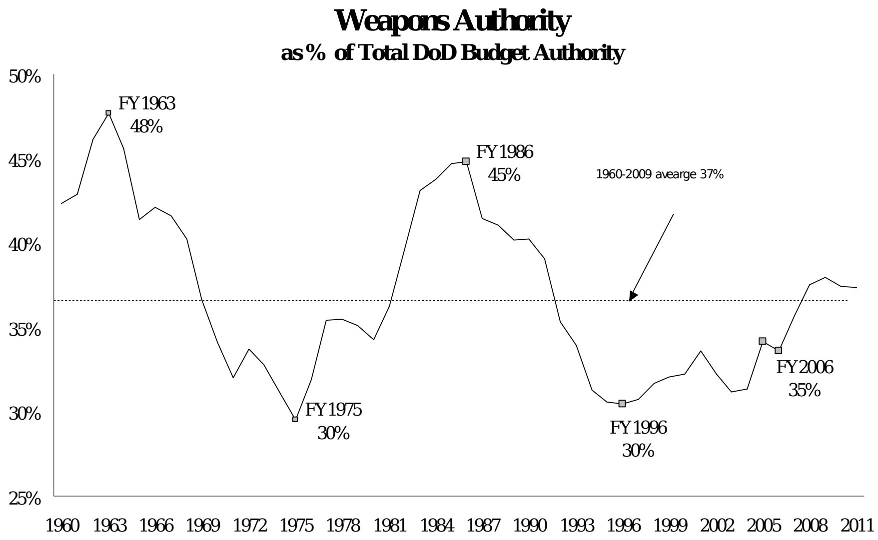
- Historic low interest rates are allowing Fed to dig deeper deficit hole than ever before
- Even Without Rate Rise, Interest Burden ~ Defense Spending By 2015

Case Against Higher Defense Spending

■*Social Security effect is cutting into overall discretionary spending*



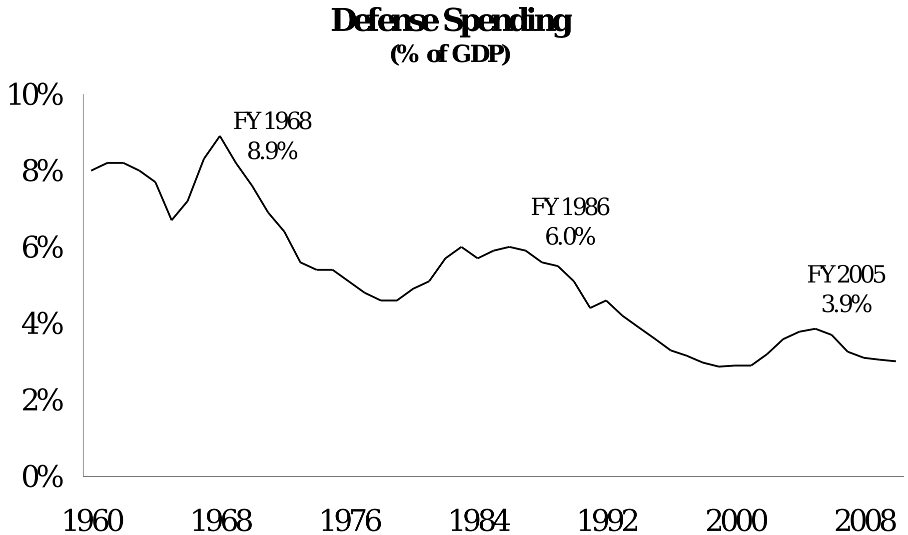
■*O&M costs from ongoing operations and aging equipment could funnel money away from weapons, ex- supplementals*



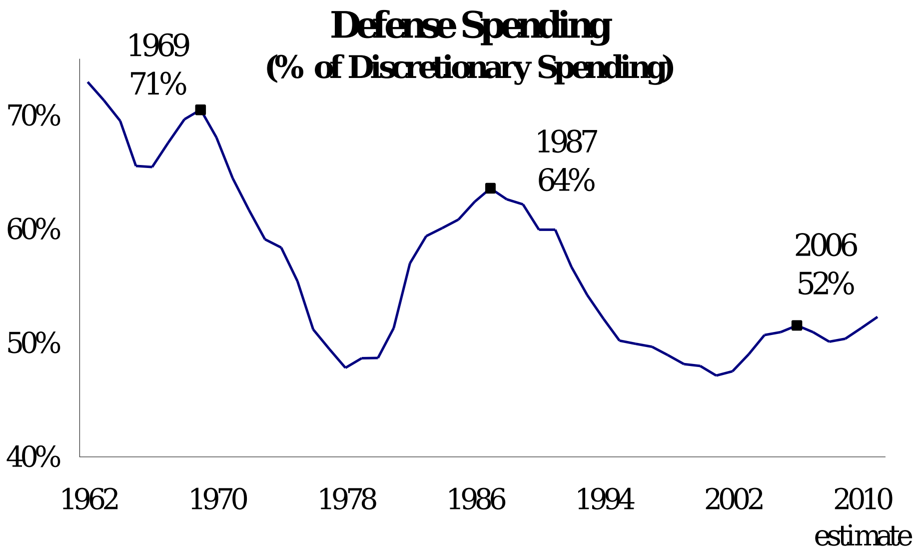
Source: OMB, Department of Defense

Case For Higher Defense Spending

- *Defense spending is still near historical lows as % of GDP*



- *Defense down to around 50% of discretionary spending*



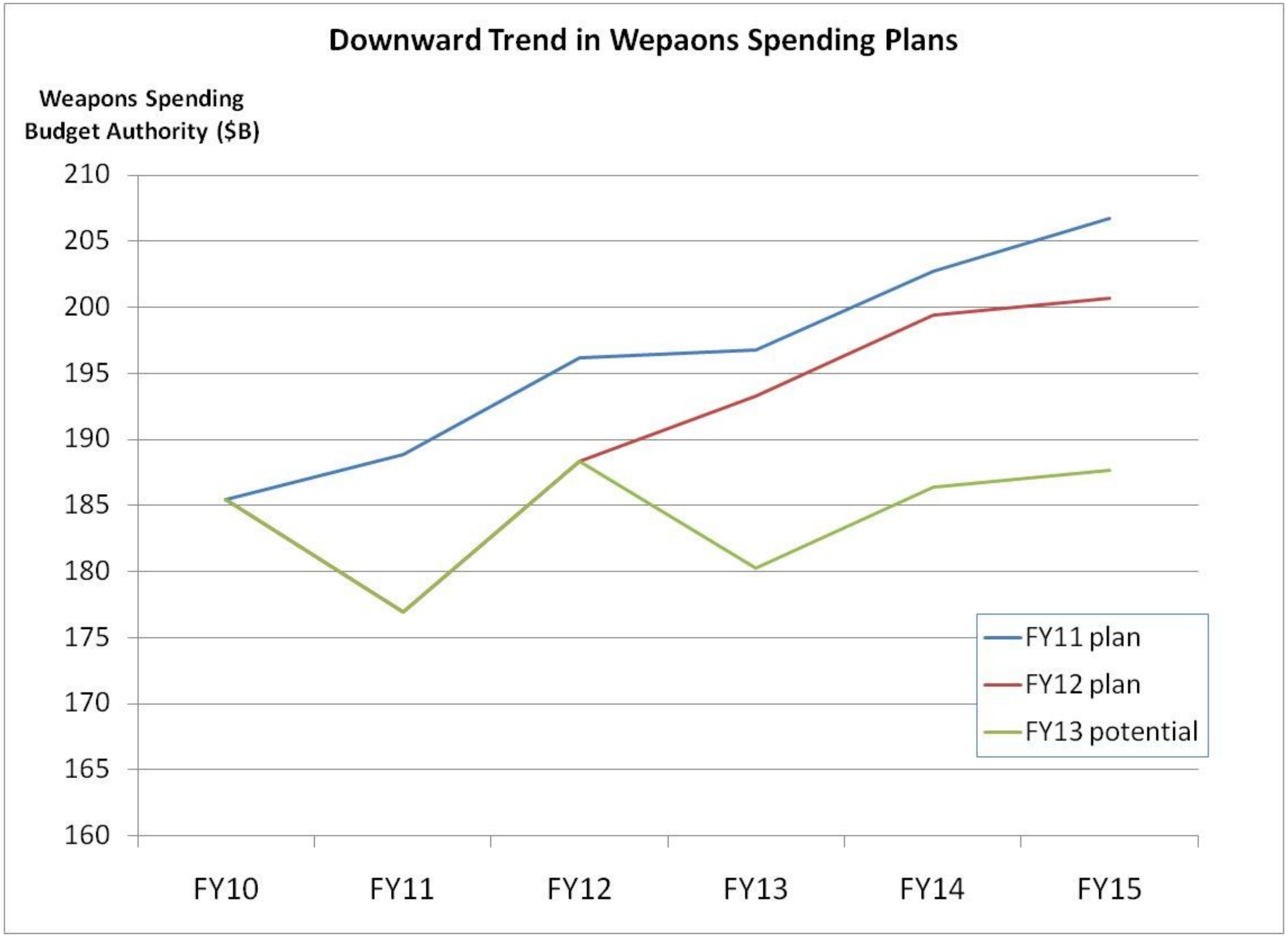
Source: OMB, Department of Defense

Sacrificial Lambs, Tough Choices, or Peanut Butter

- Sacrificial Lambs: Programs are killed as a means to protect higher valued projects, generally targets the weak, lighter backlash…Think Comanche, Crusader, VXX, EP-X, F-22
- Tough Choices: Strategic level reshuffling of priorities with resources available…Think DDG-1000 vs. DDG-51, TSAT vs. AEHF/WGS, Force Structure
- Peanut Butter: Inescapable mandatory cuts across the board; few, if any programs find sanctuary…Think Gramm-Rudman-Hollings/Pay-go

Sacrificial Lambs are the Easiest, Tough Choices is the Best….
But Peanut Butter has been (Historically) the Final Destination

Budget Believability Becoming an Issue



What Had Been a Decade of Budget Predictability Has Come to an End

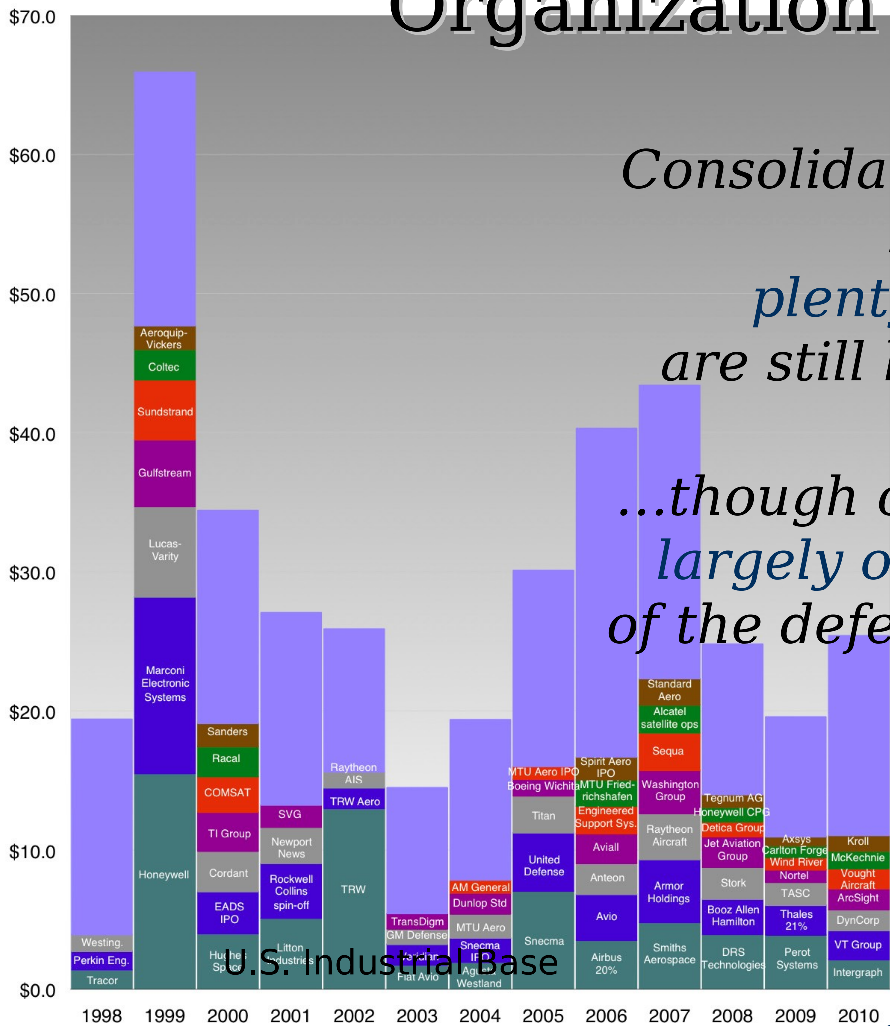
Dealing with the Downside of a Budget Cycle: Follow the Customer or the Technology?

- Strong Balance Sheets And Declining Addressable Markets Will Test Discipline
- Adjacencies Are Likely to Be Better Forged Through Customer Than Technology Know-How
- The Bad News: Sharp Drops Will Be Felt the Hardest Down the Chain
- The Good News: Sellers and Buyers Will Be Motivated to Consolidate

"Their death rays, they say, will treat cancer. Their electric rail guns will loft commercial payloads into space and enrich earthling entrepreneurs. Their nuclear reactors, originally meant for war in space, will instead hurl astronauts toward the moon and Mars."

NYT, April 8, 1990 on the Military Industrial Base Repositioning

Best Farm League Outside the Red Sox Organization



Consolidating the supply base,
plenty of deals
are still being done …

…though consolidation is
largely over at the top
of the defense food chain.

Defense-related M&A

Year	Transactions	Price/ Sales
1993	233	
1994	243	
1995	228	
1996	237	1.04
1997	251	1.15
1998	573	1.63
1999	173	1.30
2000	207	1.30
2001	343	1.15
2002	252	1.04
2003	307	1.41
2004	322	1.24
2005	371	0.85
2006	377	0.78
2007	334	1.03
2008	336	0.99
2009	240	1.17

Source: Infobase Publishers, Inc

U.S. Industrial Base

BA, GD, LMT, NOC, RTN

CSC, GE, HON, LLL, SAI, UTX

ATK, Booz, Bechtel, COL, GR, KBR, DCP, HRS, ITT, TXT, URS

HII, ARINC, Battelle, CAI, CUB, MANT, OSK, TDY (and hundreds of others)

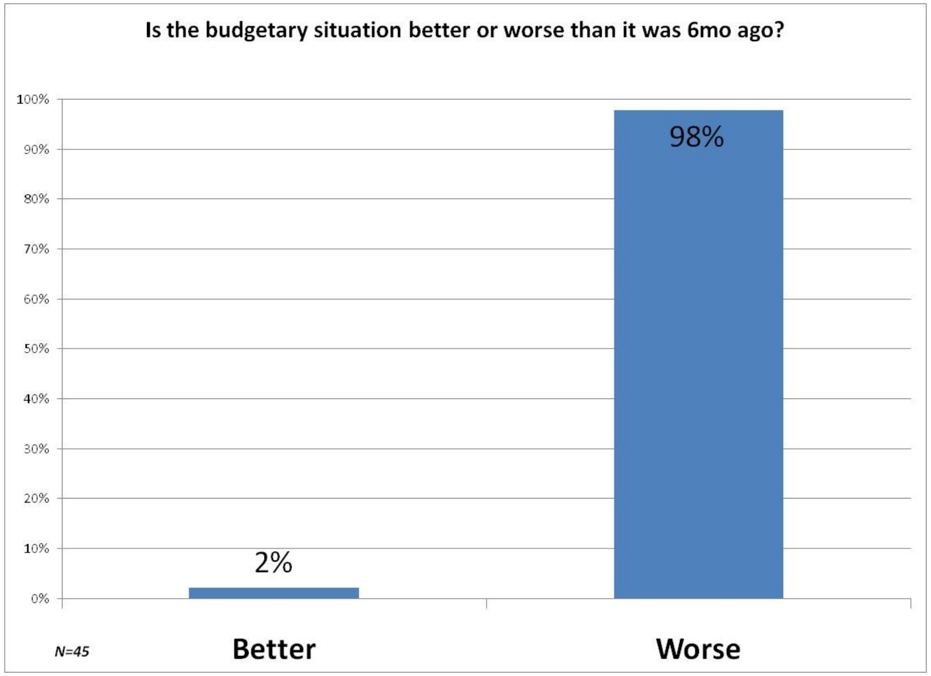
Deal Flow Will Likely Pick-up As Top-lines Flatten

Acq Reform: Some Industry Perspectives

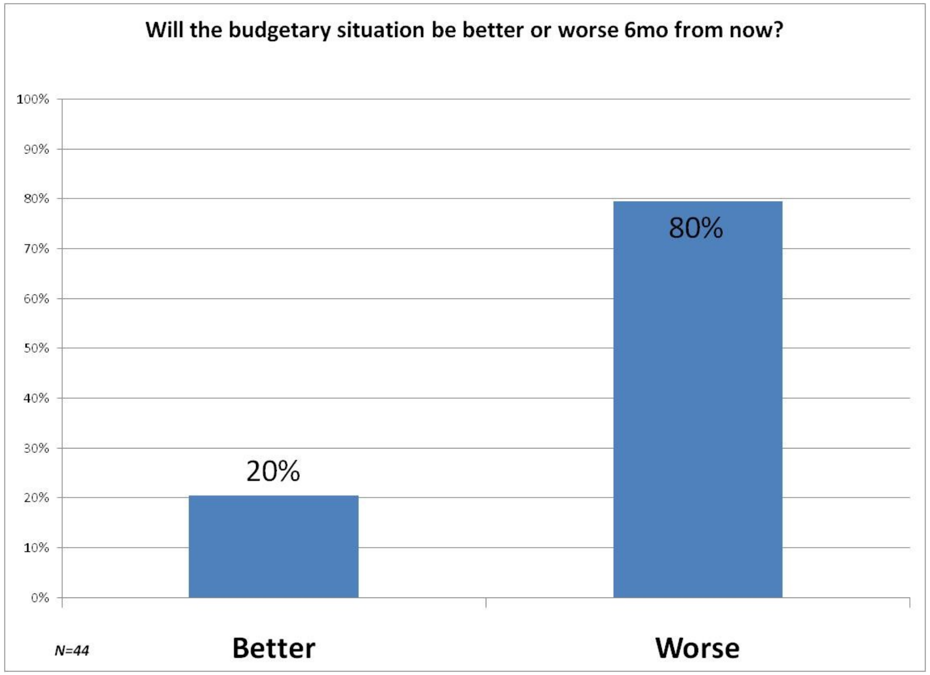
- One man’s overhead is another man’s profit
- Specifics of strategy remain unclear leading to ad hoc implementation/interpretation
- The DoD is rediscovering the power of being a monopsony customer
- If you don’t want fee on subcontracts, GFE everything and see how performance goes
- Audit rules haven’t changed, but enforcement has and industry is being given little time to adapt
- No explicit discouragement from consolidation, but rhetoric on competition seems to be counter
- Common ground on cycle-time, but not sure if the customer realizes most of that problem is on them
- Unintended consequences on competition thread (re-learning learning curves, departure of contractors, longer cycle-times)

What Are You Saying? Survey of 50 ACAT I/II PMs (1 of 3)

- *Is budgetary backdrop better/worse than 6mo ago?*

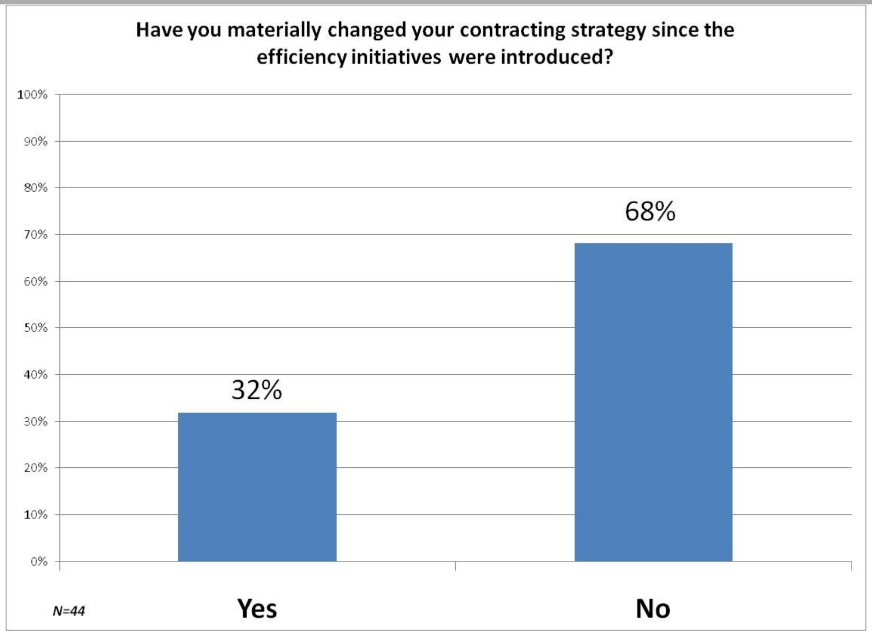


- *Will the budgetary backdrop be better/worse 6mo from now?*

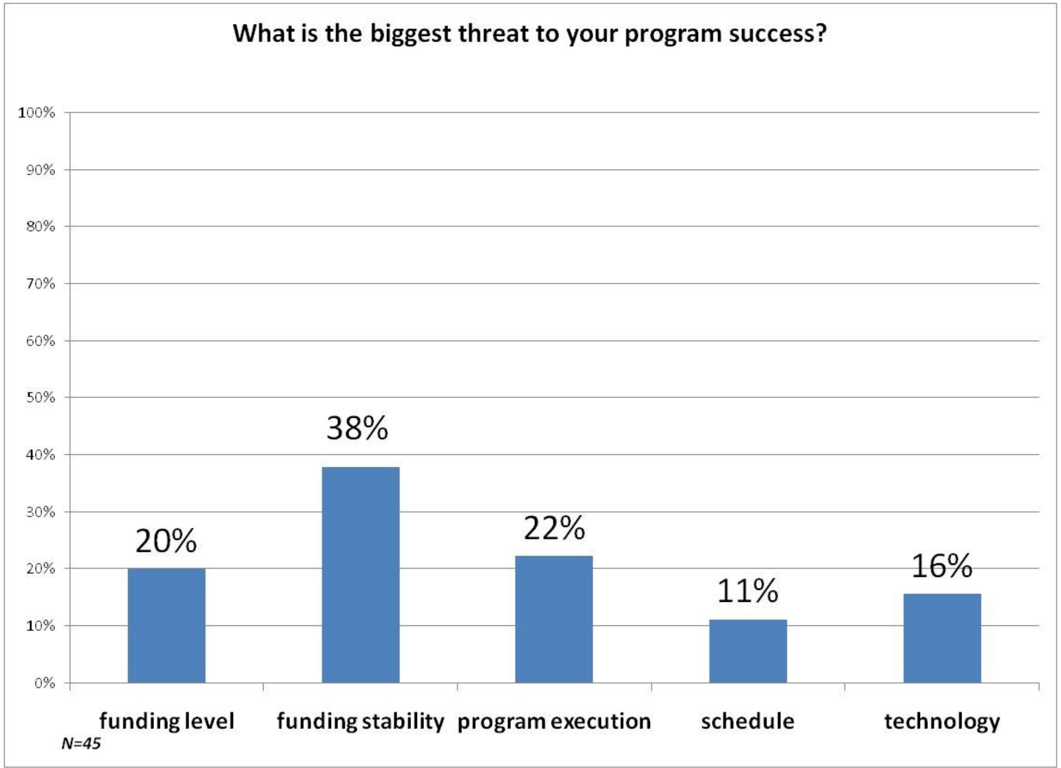


What Are You Saying? (2 of 3)

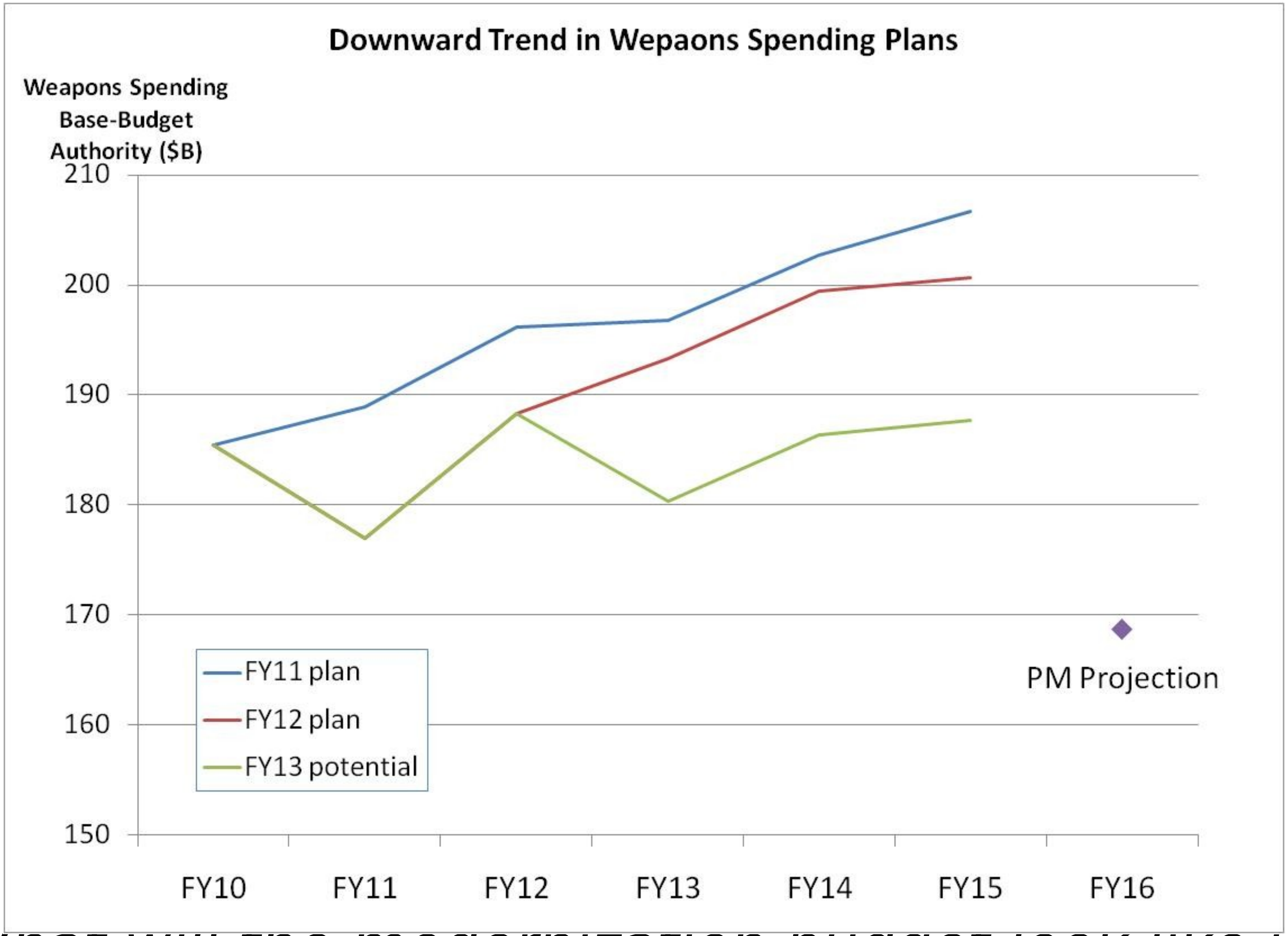
- *Have you changed your contracting in light of the efficiency initiative?*



- *What's your biggest threat to program success?*



What Are You Saying? (3 of 3)



- *What will the modernization budget look like in 5yrs?*

Incentives Give You A Clue to Actions

Show Me the Money ***(units)***

	Short Term Incentive Metrics	Long-term Incentive Metrics	Advisor
General Dynamics	earnings from cont ops ($) free cash flow from ops ($) ROIC (%) EPS ($)	same as short-term	PriceWaterhouse Coopers
Lockeed Martin	sales ($) segment op profit ($) EPS ($) cash flow ($) ROIC (%) segment op margin (%) qualitative (strategic/operational)	rel total shareholder return (%) ROIC (%) cumulative free cash flow ($)	Watson Wyat
Raytheon	bookings ($) net sales growth (%) free cash flow ($) operating profit from cont ops ($) ROIC (%)	ROIC (%) cumulative free cash flow ($) rel total stockholder return (%)	Watson Wyatt
Northrop Grumman*^	new business awards ($) operating margin rate (ex FAS/CAS) (%) net income to FCF (before voluntary pension) (%)	RONA (%) operating margin rate (%) rel total shareholder return (%)	Frederic W. Cook & Co.

**Short-term metrics prior to 2010 previously included sales ($) and free cash flow ($)*

^ For 2010, RONA or op mg rate will likely be eliminated from long-term inc; Prior to 2010 metrics were RONA (%) and op mgn rate (%);
prior to 2009 were RONA (%) and cumulative operting margin ($);
prior to 2008, metrics were cash flow return on investment (%) and cumulative operating margins ($)

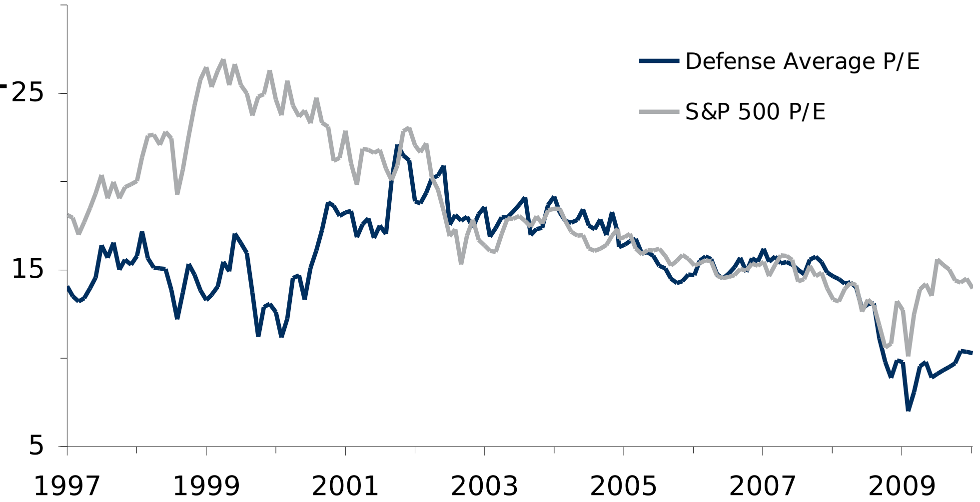
Valuation

Defense Historical P/E Analysis	Current CY12E	5 yr Historical	10 yr Historical
GAAP P/E			
General Dynamics	9.6	13.1	10.6
Lockheed Martin	9.1	14.8	12.9
Northrop Grumman	9.3	13.2	10.0
Raytheon	9.3	14.8	10.5
Average GAAP P/E	**9.3**	**14.0**	**11.0**

Source: Capital IQ

P/ E Trends

S&P and Large-cap Defense



Source: Capital IQ.

Multiples very reasonable reflecting budget uncertainty

Post 9/11, the group began to move in line with the market

Defense multiples beginning to diverge again